ST 06-0073-GIL 04/19/2006 NEXUS

This letter discusses nexus. See Quill Corp. v. North Dakota, 112 S.Ct. 1904 (1992). (This is a GIL.)

April 19, 2006

Dear Xxxxx:

This letter is in response to your letter dated January 4, 2006, in which you request information. The Department issues two types of letter rulings. Private Letter Rulings ("PLRs") are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department's regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter ("GIL") is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120. You may access our website at www.tax.illinois.gov to review regulations, letter rulings and other types of information relevant to your inquiry.

The nature of your inquiry and the information you have provided require that we respond with a GIL. In your letter you have stated and made inquiry as follows:

> We are contacting you on behalf of our client, ('Parent'). We respectfully request a legal opinion pursuant to the application of Illinois law related to nexus and the applicability of such laws to its new subsidiary's ('the Company's') operation.
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> The Company is not presently pursuing any protest litigation or negotiations with the Illinois Department of Revenue, nor is the Company currently under investigation or audit by the Department. The Company requests a legal opinion covering the proposed business to be conducted for future tax years. To the best of the Company's knowledge and the knowledge of the Company's representative, FIRM, the Department has not previously ruled on the same or similar issue for the Company. Furthermore, neither the Company, nor FIRM have previously submitted and withdrawn a similar request prior to the Department issuing a legal opinion.
>
> Please contact INDIVIDUAL if you need additional information or require further clarification regarding our request for a legal opinion.
>
> **Facts:**
>
> Our Client ('Parent) is contemplating forming a new subsidiary ('the Company'), for the purpose of selling shoes online directly to end users. The Company will be a wholly owned subsidiary of the Parent. The Parent has several other affiliates that each sell their own branded merchandise ('Sister Companies').

The Company is being formed to directly compete with other web-based, online shoe retailers selling the same or similar products. The Company will be solely an online business that will have no brick and mortar stores. The Company will be headquartered in California. The warehouse, storage space, and order fulfillment will be housed in a warehouse in Ohio separate from the other Sister Companies. Also, there will be an Ohio call center that will be located in a shared space with the other Sister Companies. With the exception of California and Ohio, it is contemplated that the Company will not have any other physical locations throughout the United States.

The Company will not have any physical presence in your state, nor does it intend to send employees, independent contractors, or perform any other in-state activities that would rise to a nexus creating activity for sales/use tax purposes. Therefore, we do not believe that the Company will have nexus for sales/use tax purposes and would like confirmation that, given the facts presented, the company would not have to collect use tax on sales made on its web site and shipped to customers in your state.

As the Parent owns other companies that do have nexus in your state, we have listed the business activities for your consideration to determine whether the activities of the Sister Companies could be attributed to the Company for the purpose of sales/use tax nexus.

The Company will be a reseller of unrelated third-party vendors' footwear, the sales of which will take place solely via the Internet. Shipment of the goods will be made from outside of your state via common carrier. The Parent of the Company also owns the Sister Companies which design, manufacture, market and sell their own private label clothing, in addition to private label shoes, through their brick and mortar stores and via the Internet on their own separately-branded websites. The Sister Companies are also different from the Company in that they do have physical stores throughout the United States, including your state. The Sister Companies collect and report sales tax on the sales made to customers in your state.

It is expected that the vast majority of the Company's sales will come from sales of products manufactured and branded by unrelated third party vendors. The shoe inventory purchased from third party vendors will likely fall under two different types of financial agreements. The first agreement would be a ‘co-marketing’ program where the third-party vendor will pay a portion of the marketing expenses. The other agreement would include ‘margin dollars’ where the third-party vendor will compensate the Company for margins that fall below a certain specified level.

It is also expected that a small minority of the sales will be made up of some combination of shoes that are manufactured and branded by the Sister Companies and acquired by the Company at wholesale prices. The Sister Companies' shoes that will be resold on the Company's website will be of a similar assortment as those available at the Sister Companies' brick and mortar stores and/or the Sister Companies' branded websites. However, given that they are separate companies, the Company's inventory will be assigned different SKUs than those of the Sister Companies. As with the purchases from third party vendors, the shoeboxes and internal packaging will be the same for the shoes purchased from the Sister Companies.

The Company will also have a written policy requiring that all returns be made directly to the Company's warehouse in Ohio. The Sister Companies will not accept returns of any merchandise sold by the Company.

In order to increase customer awareness of its brand the Company will begin a marketing campaign. In order to accomplish this, the Company will pay the Sister Companies to send out emails directing customers to the Company's website. The fee to send out the emails will be negotiated at arm's length between the companies. There will also be links from the Sister Companies' websites to the Company's separate website, for which the Company will pay an arm's length price. Furthermore, select customers from the Sister Companies may receive direct mail advertising from the Company. However, there will be no marketing of the Company or its website in the Sister Companies' brick and mortar stores.

As the Company will be headquartered in California, the majority of the Company's administrative employees will be located in California. These employees will provide administrative and management functions such as pricing, strategy decisions, et cetera. Additionally, it is expected that the Company will share corporate officers with the parent.

Because this will be a start-up company with a limited infrastructure in place in the beginning, it is expected that the Company will need to purchase certain administrative services from Parent and its affiliates.

A Parent affiliate currently operates a shared services center in New Mexico that performs various functions for the Sister Companies such as accounting, filing certain returns, et cetera. The Parent affiliate charges the Sister Companies a management fee for performing these services. This management fee is an arm's length fee for the services provided to the Sister Companies or the Parent affiliate. It is expected that the Company will enter into a similar agreement with the Parent or the Parent affiliate to provide similar types of services with a similar type of fee arrangement.

The Company will operate an online order fulfillment center and a warehouse in Ohio. The warehouse and the online order fulfillment center will be in a stand-alone building separate from the Sister Companies. Furthermore, there will be a lease stating that the Company will be renting the space from a Parent affiliate.

When a customer generates an order on the Company's website, the orders will be fulfilled via an online fulfillment center in Ohio. All decisions as to how sales orders are approved, which sales orders are approved or rejected, when sales orders are approved, credit concerns, pricing and fulfillments will be made and controlled in California and Ohio.

The Company will also operate a call center in Ohio. This call center space will be shared with space leased to the Sister Companies and each will pay rent for the use of this space. The Company will have its own call center employees that will perform such functions as order taking and assistance, technical support, product questions, return questions, and password resets.

The Company's technology infrastructure (hardware and software) will be located in California and Ohio and will be shared among all Sister Companies. The costs will be

allocated among the four Sister Companies. This infrastructure will facilitate the business processes and store the large volumes of data going through the website. While the customer-facing e-commerce technology capabilities will be custom-built and proprietary to the Company, some back-end technology capabilities will initially be leveraged amongst the Company and the Sister Companies (e.g. order management system, the warehouse management system, the technology of the marketing database, etc.). Nevertheless, there will need to be significant changes to this leveraged infrastructure in order to enable the Company's business model. The orders will be processed through a similar order management structure as the Sister Companies'; however the order management system will be completely independent from the Sister Companies' system.

Customers of the Company will be able to make purchases using their bank-issued credit card such as MasterCard or Visa and will also have the option of using the private label credit cards of the Sister Companies. The private label credit cards are currently used exclusively in the Sister Companies' brick and mortar stores and their respective branded web sites. An independent third party manages these private label credit cards. Additionally, the Company's Ohio call center will not provide answers to service questions or issues regarding the administration of the customers' private label credit cards. These calls will be handled through a non-related third party vendor.

From the Company's side, it will likely place stuffers in the shipping boxes that advertise the private label credit cards of the Sister Companies.

Customers will not be able to apply for a Sister Companies' private label credit card, pay a private label credit card bill, or perform any other functions such as a balance inquiry on the Company's website. Additionally, the Company's Ohio call center will not service questions or issues regarding the administration of the customers' private label credit cards. These calls will be handled through a non-related third party vendor.

In summary, the Company will be formed to directly compete with other web-based shoe retailers. It is a unique and separate niche market into which the Parent would like to enter to compete directly with the online shoe retailers and is different from any of their current business run through the Sister Companies.

Issues:

Will any of the following relationships/activities between the Sister Companies and the Company create sufficient nexus to require the Company to register and collect sale/use tax on shipments to customers in your state?

1. Will the nexus of the Sister Companies be attributed to the Company merely due to ownership by a common Parent?
2. By itself, will the fact that the Company will buy at wholesale from the Sister Companies' merchandise and resell it on the website create sales/use nexus for the Company in your state?
3. Will the fact that customers can use the private label cards of the Sister Companies at the Company's website create sales/use tax nexus by itself?
4. Will the link from the Sister Companies [sic] website to the website of the Company alone create nexus in your state?

5. If the Company pays the Sister Company to send out emails to their customers directing them to the Company's website, will that activity by itself create sales/use tax nexus for the company in your state?
6. Will the Company's placement of stuffers in the shipping boxes that advertise the Sister Companies' private label credit cards create sales/use tax nexus by itself?
7. By itself, will the fact that the Company purchases certain administrative services from a parent that supplies the same types of services to the Sister Companies create sales/use tax nexus in your state?
8. By itself, will sharing space with the Sister Companies within a call center that is not located in your state create sales/use tax nexus?
9. Will having a similar technical infrastructure system, which includes the order management system, the warehouse management system, the marketing database and other systems, as the Sister Companies create sales/use nexus by itself?
10. Will all of the activities above, taken together and viewed as a whole, create sales/use tax nexus for the Company?

Analysis:

I. Overview of Constitutional Restrictions

The Commerce Clause and Due Process Clause of the United States Constitution impose the primary restrictions on a state's taxing power. For a state to require a corporation to collect or pay a sales or use tax, there must be 'nexus' or some minimum connection between the corporation and the taxing state.

A. Physical Presence

The constitutional standard for a state to impose a sales and use tax collection obligation on an out-of-state seller is set forth in the U.S. Supreme Court's decision in *Quill Corporation v. North Dakota,* 504 U.S. 298 (1992). In *Quill,* the Supreme Court considered whether North Dakota could require an out-of-state mail-order company to collect use tax on goods sold to North Dakota customers. Quill had no contacts with North Dakota (except for a few computer diskettes used by customers to place orders for office supplies) other than the sale of products into the state via U.S. mail or common carrier. The court held that North Dakota was barred from imposing the tax, because the company had no outlets, sales representatives, or significant property in the state. In so ruling, the Court reaffirmed the portion of an earlier decision, *National Bellas Hess, Inc. v. Department of Revenue of Illinois,* 386 U.S. 753 (1967), that established a 'bright line' physical presence rule for the imposition of tax under the Commerce Clause.

The U.S. Supreme Court held that, while Quill had 'minimum contacts' with North Dakota sufficient to establish nexus under the Due Process Clause of the U.S. Constitution, it did not have sufficient contacts with the state to satisfy Commerce Clause nexus requirements. In *Quill,* the Court for the first time distinguished the nexus requirements of the two constitutional provisions. The Court explained that while the Due Process Clause only requires that a taxpayer purposefully direct economic activities toward a state's market, the Commerce Clause requires a higher degree of presence, 'substantial nexus,' which under *National Bellas Hess, Inc. v. Dept. of*

Revenue of Illinois, 386 U.S. 753 (1967), was not satisfied where an out-of-state seller had no physical presence in the taxing jurisdiction.

Under *National Bellas Hess* and *Quill,* a state may not impose sales or use tax on those vendors who do no more than communicate with customers in the state by mail or by common carrier as part of a general interstate business.

In the 1977 decision, *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977), the U.S. Supreme Court set forth the controlling four-part test (limitation) for state taxation under the Commerce Clause of the U.S. Constitution. According to *Complete Auto,* taxes imposed on an interstate transaction for the privilege of doing or conducting business within a state must: (1) be applied to an activity that has a substantial nexus with the state; (2) be fairly apportioned to activities carried on in the state; (3) not discriminate against interstate commerce; and, (4) be fairly related to services provided by the state. *Complete Auto* set down the threshold that all states' taxing scheme must fulfill.

Although a bright-line test for analyzing the degree of contacts necessary to create substantial nexus does not exist, certain in-state activities generally will establish nexus. For instance, the maintenance of an office or other place of business in a state is sufficient to create nexus in that state.[1]

The Court has also established that physical contact that does not exceed a 'slightest presence' will not satisfy the substantial nexus requirement.[2] Further, in *Quill,* the Court stated 'although title to a 'few floppy diskettes' present in a state might constitute some minimal nexus, in National Geographic, we expressly rejected a 'slightest presence' standard of constitutional nexus.'[3]

In *Quill,* the Court made it clear that the substantial nexus requirement imposed by the Commerce Clause imposes a more rigorous requirement than the minimum contacts which must be shown to satisfy the Due Process Clause. Thus, the question to be examined is whether the substantial nexus requirement can be met through the use of a company's agents, and what activities will be beyond the threshold of slight presence in the state.

B. Attributional Nexus

In accordance with *Quill,* a company that directs economic activities toward a state by way of mail order catalog solicitation, or presumably, any other means of solicitation such as the Internet or airwaves, but lacks any physical contact with the state, cannot be required to collect sales or use tax in the state.

Nonetheless some states have turned to alternative methods to assert nexus over out-of-state sellers. One common method is 'attributional nexus,' allowing attribution of the physical presence of a person or entity to an out-of-state taxpayer so as to confer substantial nexus over that taxpayer. Attributional nexus has been upheld by the U.S. Supreme Court in *Scripto, Inc. v. Carson,* 362 U.S. 207 (1960), and again in *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue,* 483 U.S. 232 (1987). In both decisions, independent contractors solicited sales on behalf of an out-of-state taxpayer thereby making a market for the taxpayer in the taxing state.

In *Scripto,* ten unaffiliated wholesalers conducted continuous local solicitation in Florida and forwarded orders from Florida to Atlanta for shipment of the ordered goods. The Court determined that *Scripto* was responsible for directing the actions of these salesmen in such a way as to make insignificant the title of independent contractor.[4] The Court's focus was on the market creating activity of the in-state sales representative. The direct compensation of these dealers resulted in a finding that the taxpayer was engaged in directing substantial activities of the contractors that helped establish and maintain the taxpayer's market in the state. The Court also applied this rule in *Tyler Pipe.*[5] In *Tyler Pipe,* the activities of an out-of state company's in-state independent contractor were found to establish nexus in Washington where those activities were associated with establishing and maintaining a market for the out-of-state company in the state.

II. General Principles of Agency

The Restatement (Second) of Agency (1958) defines agency as 'the fiduciary relation, which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act. The one for whom action is to be taken is the principal. The one who is to act is the agent.' Agency is a legal concept which depends upon the existence of required factual elements: the manifestation by the principal that the agent shall act for him, the agent's acceptance of the undertaking and the understanding of the parties that the principal is to be in control of the undertaking.

The hallmark characteristics of a principal/agent relationship are the right of control the principal has over the conduct of an agent and the power of an agent to alter the legal relations between a principal and third persons. A principal has the right to control the conduct of an agent with respect to matters entrusted to the agent. This control can be exercised through the principal's affirmative instructions to do an act or through the principal's directions to refrain from acting. The principal's right of control is continuous and exists as long as the agency relationship exists. The agency relationship must be distinguished from other relations in which one party acts for the benefit of another. The power of an agent is the ability of an agent to affect the legal relations of the principal in matters connected with the agency. The exercise of this power may result in the binding of the principal to a third person in contract, in divesting the principal of his interest in property, in the acquisition of new property for the principal or in the subjection of the principal to liability based on the activities of the agent while acting within the scope of the agency.

III. Illinois Law

The Illinois sales tax (ROT) is imposed on every person who engages in the business of selling tangible personal property at retail in the state.[6] 'Retail sale' or 'sale at retail' means a sale to a consumer or to any person for any purpose other than for resale, made in compliance with section 2c of the Retailers Occupation Tax Act, in the form of tangible personal property.[7] A compensating use tax is imposed at the same rate as the ROT on taxable purchases made outside the state for use within the state.[8] The responsibility of collecting and remitting sales and use tax falls on the retailer, which in Illinois includes those persons maintaining a place of business or soliciting business via employees located in the state.[9]

Illinois specifies doing business within its statutes under the definition of Retailer. Illinois requires that these 'retailers' or 'retailers maintaining a place of business' in Illinois engaged in making 'sales at retail' collect use tax. The regulation defines a retail [sic] Maintaining [sic] a place of business in the state as:

1. 'Retailer maintaing [sic] a place of business in the State', or any like term, shall mean and include any retailer having or maintaining within this State, directly or by a subsidiary, an office, distribution house, sales house, warehouse or other place of business, or any agent or other representative operating within this State under the authority of the retailer or its subsidiary, irrespective of whether such place of business or agent or other representative is located here permanently or temporarily, or whether such retailer or subsidiary is licensed to do business in this State,
2. Soliciting orders for tangible personal property by means of a telecommunication or television shopping system (which utilizes toll free numbers) which is intended by the retailer to be broadcast by cable television or other means of broadcasting, to consumers located in this State;
3. Pursuant to a contract with a broadcaster or publisher located in this state, soliciting orders for tangible personal property by means of advertsing [sic] which is disseminated primarily to consumers located in this State and only secondarily to bordering jurisdictions;
4. Soliciting orders for tangible personal property by mail if the solicitations are substantial and recurring and if the retailer benefits from any banking, financing, debt collection, telecommunication, or marketing activities occurring in this State or benefits from the location in this State of authorized installation, servicing, or repair facilities.;
5. Being owned or controlled by the same interests that own or control any retailer engaging in business in the same or similar line of business in this State.
6. Having a franchisee or licensee operating under its trade name if the franchisee or licensee is required to collect the tax under this Section;
7. Pursuant to a contract with a cable television operator located in this State, soliciting orders for tangible personal property by means of advertising which is transmitted or distributed over a cable television system in this State; or
8. Engaging in activities in Illinois, which activities in the state in which the retail business engaging in such activities is located would constitute maintaining a place of business in that state (Section 2 of the Use Tax Act)(Ill. Rev. Stat. 1989, ch.120, par. 439.2). For the purpose of determining such state of domicile, the Department will look to the place at which the selling activity takes place. The seller's acceptance of the purchase order or other contacting action in making the sale is the single most important factor in determining selling location.
9. It does not matter that an agent may engage in business on his own account in other transactions, nor that such agent may act as agent for other persons in other transactions, nor that he is not an employee but is an independent contractor acting as agent. The term 'agent' is broader than the term 'employee'. 'Agent' includes anyone acting under the principal's authority in an agency capacity.[10]

The Company clearly does not fall within the definitions as provided in subsections (i) 1 through 4 and 7 through 9 since it is not engaging in the types of activities listed. It appears that constitutional limitations, as outlined in by the Supreme Court cases Quill Corp. v. North Dakota, 112 S.Ct. 1904 (1992); *National Bellas Hess, Inc. v. Department* (of Revenue, 386 U.S. 753 (1967)) would limit the state's ability to impose a sales/use tax collection obligation under the remaining subsections (sections 4. and 5.).

The Company may engage in purposeful or systematic advertising on a national basis. However, any advertising activities that the Company engages in will be done solely via the Internet entirely outside the State of Illinois.

Additionally, the Company may be 100% owned by the same entity as its sister companies which are operating in your state but it is a completely separate business that operates entirely through the internet and has no connection to the sister companies activities within the State of Illinois. This type of relationship, despite subsections (i) 4 and 5 of the regulation above, should not be considered a physical presence in Illinois sufficient to satisfy the nexus requirements of Quill, et al.

In a private letter ruling issued by the State of Illinois an out of state mail order company was contemplating opening a retail store in state through another related company. The Department agreed that the company in the ruling did not have substantial nexus with Illinois and that the activities of its corporate affiliates in Illinois did not create nexus for the company. In that ruling, the company represented that it had no physical presence in Illinois, no employees, representatives, independent contractors, or agents operating in Illinois under its authority, no sales office, retail store, or any other real or personal property in the state of Illinois. The Department ruled that even though the company had sister companies in Illinois that did have nexus in Illinois, since the sister companies did not serve as a representative or agent of the company in Illinois, nexus would not be attributed to the company through the common ownership. The state agreed that the taxpayer did not have nexus and that the in state retail store was a completely separate entity.[11]

Therefore, because the Company will not maintain an office in Illinois nor will it have employees in Illinois, the Company clearly should not have nexus for sales and use tax purposes under the traditional nexus standards. We will address more specific provisions regarding attributional nexus in the context of the specific activities of the Company and the Sister Companies in the following discussion.

IV. Specific Activities of the Company

I. Ownership by a Common Parent

The nexus of the Sister Companies should not be attributed to the Company merely due to ownership by a common Parent.

As Listed above in Subsections (i) 4 and 5 of the regulation, it states that nexus can be created through agency and the existence of an affiliate in the state. In a private letter ruling issued by the Illinois Department of Revenue it was determined that despite the common ownership there was no nexus created when the related entity was a completely separate entity.[12]

Contrary to *Scripto and Tyler Pipe,* the Sister Companies are in no way acting on behalf of the Company in Illinois. No agency relationship exists. The two key characteristics of a principal/agent relationship are the right of control the principal has over the conduct of an agent and the power of an agent to alter the legal relations between a principal and third persons. The Company has no such control or power over the Sister Companies. The Sister Companies are not authorized to accept any orders or returns

on behalf of the Company. No promotional material for the Company ever appears in the Sister Companies' stores in Illinois.

A number of the attributional nexus cases in other jurisdictions are also instructive in addressing whether an out-of-state mail order retailer could be subject to nexus based on the presence of an in-state retail affiliate. While these cases do not address Internet sales, the treatment of mail-order sellers is directly analogous, in this context, to Internet sellers.

In *SFA Folio Collections, Inc. v. Tracy,* the court considered whether a foreign retailer that sold clothes and accessories by direct mail was subject to use tax in the state.[13] The Supreme Court of Ohio held that, despite the presence of retail stores of the sister company in the state, Folio's selling activity did not have substantial nexus with Ohio, because Folio did not have a physical presence in the state.[14] The mere presence of the affiliate did not create nexus for the foreign entity, because the affiliate did not own or operate a place of business for Folio.[15] The court reasoned that, because Folio was not incorporated in the state, had no employees or agents in the state, no bank accounts in the state, nor any other credit or collection activity in the state, Folio could not be subject to tax.[16]

Similar to the foreign entity in *SFA Folio v. Tracy,* the Company will not have any physical presence in Illinois. In fact, the activity of the foreign entity in *SFA Folio Collections, Inc. v. Tracy* constituted more 'contact' with the taxing jurisdiction than will exist in the Company's case. In *SFA Folio v. Tracy,* the retail store did accept some Folio returns in the state and distributed catalogs in the state on the foreign entity's behalf.[17] The court held this activity to be only a 'minimal connection,' insufficient to meet the requirements of *Quill.*[18]

If the activity described in *SFA Folio* v. *Tracy* is not sufficient to meet *Quill,* it logically follows that the activity of the Company in Illinois would clearly be inadequate to meet this nexus test. In the Company's case, acceptance of returns by the Sister Company's retail stores will strictly be prohibited. Furthermore, the Sister Company will not distribute catalogs on behalf of the Company.

In *Bloomingdale*'s *By Mail, Ltd.* v. *Commonwealth of PA,* a Pennsylvania court considered this nexus issue. There, the court considered whether an attempt by the Department of Revenue to require an out-of-state mail order firm to collect use tax on its mail-order sales of taxable merchandise was constitutional.[19] The mail order firm had no retail stores anywhere and did not have a distribution house, sales house, and warehouse or business location in Pennsylvania.[20] The company's only direct solicitation in the state was through catalogs distributed throughout the United States. The mail-order company's *parent company* did have retail stores in Pennsylvania and employ individuals in the state. The parent's retail stores, on limited occasions, accepted returns from the mail order company.

The court held that no nexus existed, and concluded that the following activities did not rise to the level of nexus: similar advertising themes and motifs used by both companies, purchases made by the mail-order company made on the parent company's credit card, acceptance of a small number of returns by the parent company's retail store.[21]

The Department argued that the separate corporate existence of the mail order company from the parent company's department stores was a mere legal formality.[22] The Court categorically rejected this argument, noting that 'clearly' the mail order company did not have agents acting on its behalf in Pennsylvania.[23] The Court further stressed that the burden of establishing the existence of an agency relationship rested on the party making the assertion.[24] A true agency relationship results only if there is an agreement for the creation of a fiduciary relationship with control by the principal.[25] Agency will not be assumed from the mere fact that one does an act for another.[26]

SFA Folio v. *Tracy* and *Bloomingdale*'s were distinguished by the California Court of Appeal in the recent decision of *Borders Online, LLC* v. *State Board of Equalization.*[27] There, the court held that an online bookseller with an in-state bricks-and-mortar retail affiliate had California nexus and was required to collect use tax on sales to California customers.[28] The decision focused on the return policy of the company, concluding that the company's acceptance of purchase returns constituted selling.[29] In addition to accepting returns of online purchases, the retail affiliate's sales receipts listed the online seller's web address, retail sales associates referred customers to the Web site, and the two companies had common officers, directors, and logos.[30] The court distinguished *SFA Folio* v. *Tracy* by noting that the mail order company did not initiate the return policy of the retail store.[31] The courts distinguished Bloomingdale's by noting that the returns accepted by the retail company were an aberration and were not a store policy.[32]

Consistent with the holding in *SFA Folio* and *Bloomingdale*'s and contrary to the facts described in *Borders Online,* the Sister Companies will not have authority to act on behalf of the Company in any way. In establishing nexus, the function served by the in-state representative is a crucial factor. Here, the Sister Companies will not be establishing and maintaining a market for the Company. Rather, they will be conducting their businesses of designing, manufacturing, marketing and selling their own private label clothing. The Company's market will be completely different as it is a reseller of unrelated third-party vendor's' footwear. Furthermore, the Company has a written policy requiring that all returns are made directly to the Company's warehouse in Ohio. The Sister Companies will not accept returns of any merchandise sold by the Company.

Thus, nexus should not be attributed to the Company via common ownership of the two entities.

2. Sale of Sister Company's Merchandise on Website

By itself, the fact that the Company will sell some of the Sister Companies' merchandise on its website should not create nexus for the Company in your state.

The Company will sell a number of products branded by unrelated vendors. Included in these sales will be a small minority of the Sister Companies' merchandise. These 'Sister Company' shoes will be similar in all material aspects to the other shoes sold on the website. They will be purchased by the Company at wholesale prices, just as all shoes sold by the third party vendors will be purchased.

The sale of the third party merchandise on the website, absent any other activity by the Company in the state, would surely not subject the Company to nexus in all of the states where the third Party has nexus. As such, it would be nonsensical to conclude

that the sale of the Sister Companies' shoes would create nexus for the Company in every state that the Sister Companies have nexus.

The only way in which a state may attempt to attribute nexus through the Sister Companies is through common ownership of the entities. As discussed above, a number of cases have evaluated the interrelationship of affiliates in the nexus arena.[33] All of the cases focus on the fact that there must be an additional connection between the related corporations beyond a related company name and similar inventory of merchandise to constitutionally require an out-of-state affiliate to collect sales and use tax.[34]

In *SFA Folio Collections, Inc. v. Bannon,* the Connecticut Supreme Court considered whether a foreign retailer that sold clothes and accessories by direct mail was subject to use tax in the state, because a separate corporation operated a retail store in the state.[35]
In holding that the mail order company did not have nexus with the state sufficient to impose sales and use tax, the court noted that a number of the products sold by the mail order company were also available at the retail store.[36] The court also found it relevant to its conclusion that the 'corporations are not held out to the public as one entity.'[37]

In the present case, the Company and the Sister Companies will be conducting secular businesses – one in the business of reselling footwear and one in the business of designing and selling their own private label clothing. The sale of a small percentage of 'Sister Companies' shoes by the Company, negotiated in a wholesale arrangement, should not be sufficient to allow the state of Illinois to attribute nexus to the Company. Neither the Sister Companies nor the Company will have the right to control the conduct of the other with respect to any matter related to the sale of the merchandise or otherwise.

As such, the Company's sale of some of the Sister Companies' merchandise on its website should not create sales/use tax nexus for the Company in your state.

3. Use of Sister Company's Private Label Cards

The fact that customers can use the private label cards of the Sister Companies at the Company's website should not create sales/use tax nexus by itself. Both the Pennsylvania court in *Bloomingdale's* and the Connecticut court in *SFA Folio v. Bannon* considered nexus issues in which purchases were made by the mail-order company on the parent company's credit card.[38] In concluding that no nexus existed in these cases, neither court placed importance on the use of the parent company's card.[39] Given that the courts have consistently concluded that the use of a private label credit card would not, by itself, create the requisite nexus, we believe it should be an issue here either.

As an independent third party manages the private label cards, and the Ohio call center will not answer any questions regarding these cards, it is clear that nexus would not be attributed to the Company in Illinois by allowing its customers to use these cards.

4. Link from Sister Companies Website

The link on the Sister Companies website to the Company's website should not create nexus for sales and use tax purposes in the State of Illinois.

The key issue here is whether the link constitutes solicitation in the state of Illinois on the Company's behalf. In *Tyler Pipe,* the activities of an out-of state company's in-state independent contractor were found to establish nexus in Washington where those activities were associated with establishing and maintaining a market for the out-of-state company in the state. Similarly, in *Scripto,* the court, in attributing nexus to the mail order company, noted that the only incidence of the sale transaction at issue that was *nonlocal* was the acceptance of the order.[40]

Contrary to *Tyler Pipe* and *Scripto,* any 'solicitation' on behalf of the Sister Company for the Company is nonlocal – it is all done via the Internet. All technology infrastructure for the Company and the Sister Companies is located entirely in California and Ohio. There is no local element or solicitation whatsoever in this link.

Even under the 'market making activity' standard of *Tyler Pipe,* requiring that the in-state representative's activities establish and maintain the out-of-state seller's market; Illinois would have no basis no [sic] assert attributional nexus over the Company.[41] The Sister Companies' retail stores will not market the Company or its website in any of its stores. Thus, there will be no in-state representatives establishing or maintaining the market, because there will simply be no representatives of the Company in Illinois at all.

Furthermore, the Internet Tax Freedom Act (ITFA)[42] imposed a moratorium on the imposition of state and local taxes on Internet Access[43] as well as 'multiple and discriminatory taxes on electronic commerce.' The ITFA includes in its definition of a Discriminatory Tax, a tax that 'imposes an obligation to collect or pay the tax on a different person or entity than in the case of transactions involving similar property, goods, services, or information accomplished through other means.'[44]

The Company will pay the Sister Companies a fair price, negotiated at arm's length, for this link to be accessible from the Sister Companies [sic] website, all of which will occur outside of Illinois. To impose a requirement to collect tax would clearly discriminate against the Company's chosen form of doing business over the Internet.

As such, the link on the Sister Companies website to the Company's website will not create nexus for sales and use tax purposes in the State of Illinois.

5. E-mails by Sister Company Directing Customers to the Company's Website

Similar to the link to the Company's website from the Sister Company's site, any emails by the Sister Company directing customers to the Company's website should not create nexus in the state of Illinois.

The key issue is whether the emails constitute solicitation in the state of Illinois by the Sister Companies on the Company's behalf.

The Court in *Tyler Pipe* emphasized that the important factors in establishing nexus are the nature and extent of the activities in the state on behalf of the remote seller.[45] In *Tyler Pipe,* the in-state sales representatives called on its customers daily, solicited orders continuously, and provided vital information, such as pricing, product

performance, and other critical information concerning the remote seller's state market.[46] Additionally, in *Readers Digest Assn., Inc.* the in state solicitors were the deciding factor to trigger the requirement for Illinois use tax collection.[47]

The facts presented herein contrast sharply with the scenario considered in the *Tyler Pipe and Readers Digest Assn., Inc.* decision. As noted above, all technological infrastructure of the Company and the Sister Companies will be located outside the state of Illinois. No solicitation will occur by the Sister Companies for the Company in the state of Illinois. The Company will pay the Sister Companies an arm's length price to send emails from an out-of-state location to customers throughout the United States, inviting them to visit a website hosted on a server located outside the state.

Nevertheless, the ITFA imposed a moratorium on 'multiple and discriminatory taxes on electronic commerce.'[48] If the state of Illinois required collection of tax due to emails that arrived in the inbox of an Illinois resident, this requirement would clearly be discriminatory based on the Company's chosen forum for doing business.

As such, the emails the Sister Companies will send to its customers directing the customers to the Company's website should not create nexus for sales and use tax purposes in the State of Illinois.

6. Placement of Stuffers in Shipping Boxes Advertising Private Label Credit Cards

By itself, the Company's placement of stuffers in shipping boxes advertising the private label credit cards of the Sister Companies should not create nexus in your state for sales/use tax purposes.

The Sister Companies have physical stores in your state and already collect and report sales tax on the sales made to customers in your state. Additional contact with the state, through this advertisement, will be irrelevant because the Sister Companies admittedly have nexus and collect sales tax in Illinois.

It follows that the Company's act of placing an advertisement in the shipping boxes after the sale is to be made should not create nexus for the Company in the state of Illinois. The nexus-creating activities listed in 35 ILCS 105/3, and all of the court decisions discussed herein related to attributional nexus, focus on the activities of the in-state corporation *on behalf of* the out-of-state seller.[49] Here, after a sale will already be made by the Company, it will be including an advertising insert for the Sister Companies' credit cards.

The Company will not be purposefully availing itself of the Illinois market with this action, because this action in no way impacts the Company's own market in Illinois.[50] As such, the Company's placement of stuffers in shipping boxes advertising the private label credit cards of the Sister Companies should not create nexus in your state for sales/use tax purposes.

7. Purchase of Administrative Services

By itself, the fact that the Company will purchase certain administrative services from a parent that supplies the same types of services to the Sister Companies should not create sales/use tax nexus in your state.

The shared services center will be located outside of the state and provides various functions to the Sister Companies. The Parent affiliate currently charges an arms length management fee to its subsidiaries for providing these services. The Parent affiliate will similarly charge the Company a fee negotiated at arm's length. An arm's length price is the price at which a willing buyer and a willing unrelated seller would freely agree to transact. If the Company purchased these services from a third-party provider, there would be no question about whether the state could attribute nexus from the third-party to the Company.

This transaction will be no different than any other third party outsourcing arrangement. None of these services will be performed in the state of Illinois, so the issue again is whether the common ownership of the Sister Companies and the Company would allow the state to attribute nexus to the Company in the state of Illinois.

The Connecticut Supreme Court, in *SFA Folio Collections, Inc.* v. *Bannon,* considered whether a foreign retailer that sold clothes and accessories by direct mail was subject to use tax in the state, because a separate corporation operated a retail store in the state.[51] The court held that the mail order company did not have nexus with the state sufficient to impose sales and use tax.[52] The court specifically ruled that the out-of-state seller's separate corporate existence should not be disregarded.[53] The court reasoned that, because the corporate assets of the two entities had not been intermingled and because the separate corporate procedures had not been ignored, the state could not assert nexus sufficient to require the mail-order company to collect use tax. [54]

Consistent with the principle applied in the Connecticut decision in *SFA Folio,* and as discussed herein,[55] the purchase of administrative services from the Company's parent company, to be performed outside the state, will not intermingle corporate procedures. Rather, it will simply be a manner in which the Company can efficiently outsource some of its operational needs.

The purchase of administrative services should not create nexus in Illinois sufficient to require the collection of use tax.

8. Sharing Space with Sister Companies Call Center

By itself, sharing space with the Sister Companies within a call center that will not be located in your state should not create sales/use tax nexus. The space will be leased to the Company and the Sister Companies, and both parties will pay rent to the parent.

As discussed above, the reasoning in *SFA Folio Collections, Inc.* v. *Bannon,* in recognizing the out-of-state seller's separate corporate existence, focused on the importance of separating the day-to-day corporate functions.[56] In concluding that the foreign retailer was not subject to use tax in the state, the court relied on the fact that the companies operated separately and autonomously.[57] Additionally, in *Readers Digest Assn., Inc.* the focus was entirely on the activities within the State of Illinois.[58]

In the Company's case, the call center will be entirely bifurcated for the Company's operations. The Company's own employees will perform all vital tasks--including taking orders, assisting customers with product questions and technical support, and answering other return policy questions. The Sister Companies [sic] representatives at the call center will in no way be acting on behalf of the Company. All shared activities occur entirely outside of the State of Illinois.

This stark separation of duties exceeds the separation of duties in *SFA Folio,* because the foreign entity in that case actually sent extra copies of its catalog to the retail [sic] to be used as reference guides and educational tools.[59] As such, the shared space, as contemplated, should not create sales and use tax nexus for Illinois purposes.

9. Similar Technical Infrastructure

Possession of a similar technical infrastructure system as the Sister Companies, which includes the order management system, the warehouse management system, and the technical functionalities of the marketing database, should not create nexus by itself. The order management system will be completely independent from the Sister Companies' system.

As elaborated in *SFA Folio,* it is 'a fundamental principle of corporate law that 'the parent corporation and its subsidiary are treated as separate and distinct legal persons even though the parent owns all the shares in the subsidiary and the two enterprises have identical directors and officers. Such control, after all, is no more than a normal consequence of controlling share ownership.'[60]

In the Company's case, a natural consequence of controlling shared ownership is the leveraging of efficiencies. While the Company will be engaging in an entirely different and unique business than the Sister Companies, there will still be some functions, such as warehouse management and order management, which operate similarly.

This mere similarity of operational functions is a normal consequence of shared ownership as well as best practices, and should in no way give rise to nexus for sales and use tax purposes in the state of Illinois.

10. Activities Taken Together

All of the activities above, taken together and viewed as a whole, should not create sales/use tax nexus for the Company. Based on the constitutional restrictions, Illinois law, and relevant decisions of other jurisdictions, there must be some additional connection, beyond common ownership and arm's length business transactions between the entities, to constitutionally require an out-of-state affiliate with no physical presence in Illinois to collect sales and use tax. None of the individual activities give rise to nexus in the state of Illinois sufficient to impose a collection responsibility upon the taxpayer.

Because the Company will be a unique and a separate business from the sister entities, it appears that, given the facts as stated, there would not be a requirement to collect tax on sales made to customers in Illinois at this time.

General Information Letter Request:

Given the facts and analysis as set forth herein, we do not believe that the Company is required to register and collect sales and use taxes in the state of Illinois. We respectfully request that the Department confirm our conclusions as set forth above, so that we may advise our client accordingly. We are aware that the Department of Revenue's reply to this ruling request will not be binding on either the Department of Revenue or the taxpayer unless we follow-up with a letter as prescribed under 2 Ill. Adm. Code 1200.110(b).

We appreciate your assistance with this matter. If you have any questions or need additional information regarding this request, please feel free to call me.

DEPARTMENT'S RESPONSE:

Determinations regarding nexus are very fact specific and cannot be addressed in the context of a General Information Letter. The Department has found that the best manner to determine nexus is for a Department auditor to examine all relevant facts and information. The following guidelines, however, may be useful to you in determining whether your company would be considered "a retailer maintaining a place of business in Illinois" subject to Use Tax collection obligations.

An "Illinois Retailer" is one who either accepts purchase orders in the State of Illinois or maintains an inventory in Illinois and fills Illinois orders from that inventory. The Illinois Retailer is then liable for Retailers' Occupation Tax on gross receipts from sales and must collect the corresponding Use Tax incurred by the purchasers.

Another type of retailer is the retailer maintaining a place of business in Illinois. The definition of a "retailer maintaining a place of business in Illinois" is described in 86 Ill. Adm. Code 150.201(i). This type of retailer is required to register with the State as an Illinois Use Tax collector. See 86 Ill. Adm. Code 150.801. The retailer must collect and remit Use Tax to the State on behalf of the retailer's Illinois customers even though the retailer does not incur any Retailers' Occupation Tax liability.

The United States Supreme Court in Quill Corp. v. North Dakota, 112 S.Ct. 1904 (1992), set forth the current guidelines for determining what nexus requirements must be met before a person is properly subject to a state's tax laws. The Supreme Court has set out a 2-prong test for nexus. The first prong is whether the Due Process Clause is satisfied. Due process will be satisfied if the person or entity purposely avails itself or himself of the benefits of an economic market in a forum state. Quill at 1910. The second prong of the Supreme Court's nexus test requires that, if due process requirements have been satisfied, the person or entity must have physical presence in the forum state to satisfy the Commerce Clause. A physical presence is not limited to an office or other physical building. Under Illinois law, it also includes the presence of any agent or representative of the seller. The representative need not be a sales representative. Any type of physical presence in the State of Illinois, including the vendor's delivery and installation of his product on a repetitive basis, will trigger Use Tax collection responsibilities. Please refer to Brown's Furniture, Inc. v. Wagner, 171 Ill.2d 410, (1996).

The final type of retailer is the out-of-State retailer that does not have sufficient nexus with Illinois to be required to submit to Illinois tax laws. A retailer in this situation does not incur Retailers' Occupation Tax on sales into Illinois and is not required to collect Use Tax on behalf of its Illinois

customers. However, the retailer's Illinois customers will still incur Use Tax liability on the purchase of the goods and have a duty to self-assess and remit their Use Tax liability directly to the State.

I hope this information is helpful. If you require additional information, please visit our website at www.tax.illinois.gov or contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

Edwin E. Boggess
Associate Counsel

EEB:msk

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[1] *National Geographic Society v. California Bd. of Equalization,* 430 U.S. 551 (1977).
[2] Id.
[3] *Quill,* 504 U.S. at 315 n. 8.
[4] *Scripto v. Carson,* 362 U.S. 207, 211 (1960).
[5] Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue, 483 U.S. 232 (1987).
[6] IL ST CH 35 § 105/2
[7] IL ST CH 35 § 105/2
[8] 86 ILAC § 150.201
[9] 35 ILCS 120/2
[10] 86 ILAC § 150.201(i)
[11] Illinois PLR, ST 96-0378, Illinois Department of Revenue
[12] Id
[13] *SFA Folio Collections, Inc. v. Tracy*, 73 Ohio St.3d 119 (1995).
[14] *Id.* at 123.
[15] *Id.*
[16] *Id.* at 122.
[17] *Id.* at 123.
[18] *Id.*
[19] *Bloomingdale's By Mail, Ltd. v. Commonwealth of Pennsylvania Department of Revenue,* 130 Pa.Cmwlth. 190, 191 (1989).
[20] *Id.* at 198.
[21] *Id.*
[22] *Id.*
[23] *Id.*
[24] *Id. At 198-199*.
[25] *Id.*
[26] *Id.*
[27] *Border's Online, LLC v. State Board of Equalization,* 129 Cal.App.4th 1179 (2005).
[28] *Id.*
[29] *Id.* at 1193.
[30] *Id.* at 1199.
[31] *Id.*
[32] *Id.*
[33] See, for e.g., *SFA Folio* v. *Tracy, Bloomingdales, Borders Online.*
[34] *Letter Ruling* 05-7, *State of Massachusetts, November* 8, 2005.
[35] *SFA Folio Collections, Inc.* v. *Bannon,* 217 Conn. 220 (1991).
[36] *Id.* at 224. Note that the court noted that many of the similar products sold were also available at other retail stores throughout the country, but did not appear to consider this fact in its opinion.
[37] *Id.* at 233-234.
[38] *Bloomingdale's By Mail, Ltd.,* 130 Pa.Cmwlth. at 193; *SFA Folio Collections, Inc.,* 217 Conn. at 225.

[39] *Bloomingdale's By Mail, Ltd.,* 130 Pa.Cmwlth. at 199; *SFA Folio Collections, Inc.,* 217 Conn at 225, 234.
[40] *Scripto*, 362 U.S. 207 at 211.
[41] *Tyler Pipe,* 438 U.S. at 250.
[42] Internet Tax Freedom Act, Pub. L. No.105-277, 112 Stat. 2681-719,47 U.S.C. § 151 note (1998) (amended by Internet Tax Nondiscrimination Act, 107 P.L. 75,115 Stat. 703,47 U.S.C. § 609 note (2001)).
[43] 'Tax on Internet access' is defined as a tax on Internet access, including the enforcement or application of any new or preexisting tax on the sale of use of Internet services unless such tax was generally imposed and actually enforced prior to October 1,1998. ITFA § 1104(10).
[44] ITFA § 1104 (2)(A)(iii).
[45] *Tyler Pipe.* 438 U.S. at 250-251.
[46] *Id.* at 250 (quoting the Washington State Supreme court's factual summary).
[47] *Readers Digest Association, Inc.*, 44 IlI2d. 354, 255 N.E.2d 458
[48] 'Tax on Internet access' is defined as a tax on Internet access, including the enforcement or application of any new or preexisting tax on the sale of use of Internet services unless such tax was generally imposed and actually enforced prior to October 1, 1998. ITFA § 1104(10).
[49] *See, for e.g., SFA Folio Collections, Inc. v. Tracy,* 73 Ohio St. 3d 119 (1995); *Bloomingdale's by Mail, Ltd. v. Commonwealth of Pennsylvania Dept. of Revenue*, 567 A.2d 773 (1989).
[50] *See, for e.g., Scripto*, 362 U.S. at 211.
[51] *SFA Folio Collections, Inc. v. Bannon*, 217 Conn. 220 (1991).
[52] *Id.* at 234-235, 239.
[53] *Id.* at 232.
[54] *Id.* at 233.
[55] *See* discussion in Subsection IV.A.
[56] *SFA Folio Collections, Inc. v. Bannon*, 217 Conn. at 233
[57] *SFA Folio Collections, Inc. v. Bannon*, 217 Conn. at 224.
[58] *Readers Digest Assn., Inc.*, 44 Ill.2d 354, 255 N.E.2d. 458
[59] *Id.*
[60] *Id.* at 232.